

Oct. 26. 2009 / 12:30PM, VZ - Q3 2009 Verizon Earnings Conference Call

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*Verizon - SVP, IR*

**John Killian**

*Verizon - EVP & CFO*

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**Simon Flannery**

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## PRESENTATION

**Operator**

Good morning and welcome to the Verizon third-quarter 2009 earnings conference call. (Operator Instructions). Today's conference is being recorded. If you have any objections, you may disconnect at this time. It is now my pleasure to turn the call over to your host, Mr. Ron Lataille, Senior Vice President Investor Relations for Verizon.

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**Ron Lataille - Verizon - SVP, IR**

Good morning and welcome to our third-quarter 2009 earnings conference call. Thanks for joining us this morning. I'm Ron Lataille. With me this morning are Ivan Seidenberg, our Chairman and Chief Executive Officer, and John Killian, our Chief Financial Officer.

Before we get started, let me remind you that our earnings release, financial statements, the investor quarterly publication and the presentation slides are available on our Investor Relations website. This call is being webcast. If you would like to listen to a replay, you can do so from our website.

I would also like to draw your attention to our Safe Harbor statement. Information in this presentation contains statements about expected future events and financial results that are forward-looking and subject to risks and uncertainties. Discussion



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of factors that may affect future results is contained in Verizon's filings with the SEC which are available on our website. This presentation also contains certain non-GAAP financial measures. Reconciliations of these non-GAAP measures to the most directly comparable GAAP measures are also on our website.

Next, I would like to quickly cover the difference between reported and adjusted earnings for the third quarter. In the third quarter, reported earnings per diluted share were \$0.41. Adjusted earnings per share before the effects of special items were \$0.60.

We are excluding the following special items from adjusted results. The first item is an after-tax charge of \$372 million or \$0.13 per share for pension settlement losses resulting from our separation plans. Pension accounting rules require that settlement losses be recorded once prescribed payment thresholds have been reached. The next item is an after-tax charge of \$103 million or \$0.04 per share which is for merger integration and acquisition costs relating to Alltel.

We are also excluding a \$41 million after-tax charge or \$0.02 per share for non-operational costs incurred in connection with the spinoff of our local exchange business in 14 states. These costs are primarily related to network, software and other activities required for these facilities to function as a separate company.

With that, I will now turn the call over to John Killian.

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**John Killian** - Verizon - EVP & CFO

Thanks, Ron, and good morning to everyone. Before we get into the details of the third quarter, I want to make just a few general comments.

When I look at the quarter, I believe the results showed good financial discipline throughout the business, which is driving excellent growth and cash flow from operations and free cash flow. We continue to tightly manage capital spending, and while the economy continues to create headwinds for us, we are taking steps to offset the current impacts as much as possible. And I'm confident that as the economy gets better we will see improvements in our results.

We are also taking longer-term actions to significantly reduce our cost structure to improve productivity as our business evolves.

With that, starting on slide three, you can see that we produced \$0.60 of adjusted earnings per share in the third quarter, bringing our year-to-date total to \$1.86 per share. Cash flow from operations of \$23.1 billion in the first nine months increased \$3.2 billion or 16% year over year, driven by strong cash generation in Wireless.

Free cash flow of \$10.7 billion year-to-date was significantly higher than last year, up \$3.3 billion or 45%. We have seen strong cash flow growth each quarter this year and particularly this quarter, reflecting growth in strategic areas and our continued focus on operating and capital discipline. Capital expenditures, including amounts related to our Alltel acquisition, were down \$125 million or 1% year-to-date, reflecting the tightness with which we are managing capital, and our CapEx to revenue ratio continues to improve.

As you know, our board of directors approved a 3.3% dividend increase in September, which on an annual basis increases our dividend from \$1.84 to \$1.90 per share. This is the third consecutive year that our board has approved a dividend increase for a cumulative total of 17.3%. These dividend increases demonstrate our board's confidence in the strength of our cash flow and balance sheet, our financial discipline and our commitment to return cash to shareholders while continuing to invest for long-term growth.

We also reduced debt this quarter. On a consolidated basis, net debt at the end of the third quarter was \$61.6 billion, down \$2.5 billion since the end of June, which is about 1.7 times EBITDA for the last 12 months on a pro forma basis.





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Let's take a closer look at the revenue trends starting on slide four. In spite of the challenging environment, third-quarter consolidated revenues grew both sequentially and year over year. Similar to last quarter, topline results were mixed. All of our strategic areas continue to post good growth, particularly wireless data and FiOS, but we continue to see weakness in the business markets, primarily in volume-driven voice products.

Let's move to the segments next, starting with Wireless on slide five. Our Wireless business turned in another quarter of solid revenue growth, industry-leading profitability and exceptionally strong cash generation. Total operating revenues for the quarter were \$15.8 billion, up 24.4% from a year ago. On a pro forma basis, total operating revenue growth was 4.9%, while total service revenue was up 6.1% year-over-year.

EBITDA was \$6.2 billion in the quarter, up 9.2% from last year on a pro forma basis, and our EBITDA margin on service revenue remained very strong at 46.1%. Wireless capital spending was \$1.8 billion in the third quarter, bringing us to a year-to-date total of \$5.1 billion. EBITDA less CapEx was \$13.3 billion year-to-date, which is very strong cash flow performance.

The integration of Alltel is going according to plan. Our store rebranding efforts across the country are complete. Network conversions are well underway and on track. Essentially all of the former postpaid Alltel customers have been converted to our billing system, and prepaid customers will be completely converted by the end of November.

So another quarter of disciplined performance by our Wireless business as we continue to effectively balance both growth and profitability.

Let's take a closer look now at the Wireless retail market on slide six. Retail continues to be our primary focus and represents the largest portion of our Wireless business. 97% of our 89 million customer base is retail. 81 million or 91% are retail postpaid subscribers.

In terms of customer growth, we continue to take a strong share of overall gross adds and maintain excellent churn metrics. Gross adds were 5.2 million in the quarter. Total net adds were 1.2 million with 970,000 retail additions, 943,000 of which were retail post-paid. Net adds from resellers totaled 270,000 in the quarter, including one-time customer conversions from some of our reseller partners. An example would be GreatCall, which announced in August, that its Jitterbug cell phone would utilize the Verizon Wireless network through our open development program.

I would also note that we have no arrangements with resellers that provide for unlimited usage for a fixed price. My key point here is that we look for opportunities to capture share in both the retail and reseller markets on a profitable basis. But, as I said earlier, our primary focus continues to be on the retail post-paid market.

Moving to our churn metrics, retail postpaid churn of 1.13% was up 5 basis points year over year, and total churn was up 6 basis points, which are improvements over the past several quarterly comparisons. We continue to attribute these upticks primarily to cyclical factors that have driven business customer-related disconnects to PC cards and voice lines.

Retail service revenue in the third quarter grew 6.4% year over year. Retail postpaid ARPU of \$52.78 was stable with 0.2% growth compared with the third quarter last year. We did see some year-over-year declines this quarter in air time usage and prepaid and reseller, which resulted in a 0.5% decline in retail service ARPU and a 0.8% decline in total service ARPU. We still believe that strong data growth will continue to offset pressures on the voice side, particularly in our retail postpaid base. The continued introduction of new smartphone devices and increased adoption of mobile broadband applications should drive retail postpaid ARPU and overall revenue growth.

Total data revenues as highlighted on slide seven topped the \$4 billion mark this quarter, up more than \$900 million or nearly 29% growth. Growth in wireless data has been nothing short of remarkable. Think about this. In 2006 data revenues for the year totaled \$4 billion. Now less than three years later, we are generating \$4 billion per quarter, and we are planning for continued growth driven by increasing mobile broadband adoption and innovative new applications.



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Total data ARPU was up 20.7%, and retail data ARPU was slightly higher with 21.6% growth. Data revenues represented just over 30% of total service revenues this quarter compared with 25% a year ago.

Non-messaging services, which make up about 60% of total data revenue, increased 34% compared with third quarter last year. Clearly more and more customers are taking advantage of data products and applications that leverage our extensive 3G data network capabilities. Messaging, which makes up the remaining 40% of data revenue, grew 22% versus the same quarter last year.

PDA's and smartphone sales remained strong, once again representing about 40% of new device sales this quarter. The percentage of retail postpaid customers with these devices nearly doubled in the past year and now represent 23% of our base. And there is certainly upside to further penetration as we introduce more of these high-end devices, which generally require data plans.

In addition, continued growth in mobile broadband devices, including new products like netbooks and MiFi devices, are also helping to expand the wireless data market.

We also recently expanded our data pricing plans to include two new lower cost, usage-based options for customers with feature phones who may not necessarily want to pay for unlimited data. We think the new plans will be attractive for moderate data users and will stimulate demand and expand the market.

So looking ahead in the Wireless market, we see plenty of revenue growth opportunities, driven, of course, by mobile broadband. We see several catalysts for the next phases of growth, including innovative devices, applications and content, and the much higher bandwidth and capacity of 4G technology.

In the near term, we are very excited about our new device lineup, which we think will create demand and stimulate further broadband data usage. We also see exciting developments in terms of applications and content, including the launch of our V CAST Applications store soon.

Our recent announcement with Google, which leverages our network and the Android open platform, gives us a great opportunity to innovate and accelerate delivery of unique applications to customers. The 4G technology evolution with LTE is a huge growth opportunity for us and one that we believe we are uniquely positioned to capitalize on. We have the largest and most reliable 3G network today, and we will extend our leadership position with our 4G network. We are on schedule for commercial introduction of LTE next year with 25 to 30 markets covering approximately 100 million pops by year-end. We expect to have nationwide 4G coverage with LTE, featuring our contiguous coast to coast 700 MHz spectrum with its unmatched capabilities for speed and network efficiency by the end of 2013.

Let's move now to our Wireline segment on slide nine. In the Wireline business, FiOS continues to gain scale, and broadband and video drive growth in consumer revenue. As I mentioned earlier, business revenues have been adversely affected by the economy. But we are competing well, and we had several large customer wins in the enterprise market in the last few months.

From a profitability perspective, Wireline margins continue to be pressured by both cyclical and secular effects, as well as incremental pension and OPEB costs. EBITDA declined \$69 million sequentially, resulting in an EBITDA margin of 23.7% this quarter. We expect margins will improve over time through a combination of better revenue performance, an improving economy, ongoing work force reductions and other cost-saving initiatives.

Earlier this month we announced a reorganization of our Wireline segment. We believe combining our Telecom and Business groups into one will enhance our effectiveness and more significantly reduce our costs. I will provide more details on our Wireline transformation and cost initiatives in a few minutes. But before I get to that, let's take a closer look at Wireline revenues, starting with mass markets.





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In mass markets, demand for our broadband and video products continues to drive revenue and ARPU growth. Consumer revenues in the third quarter grew 1.2% over last year. Quarterly FiOS revenues totaled more than \$1.4 billion, up 56% compared with the third quarter last year. Consumer ARPU also increased to just over \$75 this quarter, up 12.6% from a year ago, and FiOS ARPU remains very strong at more than \$137 per month.

Let's take a closer look at our FiOS results on slide 11. On a year-to-date basis, we have added about 18% more FiOS TV and Internet customers than last year. This growth comes from both new markets and deeper penetration in existing markets. In the third quarter, we added 191,000 FiOS TV and 198,000 FiOS Internet customers, increasing our penetration to 25% for TV and 29% for Internet. Although net adds were less than the record adds of the last two quarters, FiOS continues to have good momentum in the market. Churn remained low in the quarter. Gross sales were lower, primarily due to a change in promotional activity.

Overall we are on track from a deployment standpoint with about 45% of our premises passed. FiOS Triple Play availability has expanded to 10.9 million homes or about 34% of total households. And last week we announced new Quad-Play and Triple Play bundles in several East Coast markets. So we continue to believe we can add about 1 million new FiOS customers each year.

Let's turn next to the rest of our Wireline revenues, which included global enterprise and global wholesale. In our global markets, I see mixed results and a continuation of some trends that have been affecting both the retail and wholesale markets.

On the positive side, we generated sequential growth of 2.5% in global enterprise revenues in the third quarter, primarily driven by continued demand for IP services. We also had a smaller impact from foreign exchange effects in the quarter. However, the cumulative effect of unemployment continues to impact usage volumes. We are also not seeing any significant change in capital or IT spending by our large customers.

The primary leading indicator for sustained improvement in the business market will be a return to hiring on the part of our enterprise customers. We did see a pickup in CPE sales from our existing customers this quarter, but not enough for me to get too optimistic.

While certain volume metrics have shown some stabilization, I'm still not seeing meaningful improvement. For example, enterprise business long-distance voice minutes were down 4.5% year over year but were stable on a sequential basis. So while I am certainly not comfortable calling a bottom, I would say that I'm cautiously optimistic.

As I said a few minutes ago, we had several very good wins this quarter, including JetBlue, Manulife Financial and several government contracts. Some of these wins included integrated IT and communications solutions, as well as security and consulting services. Enterprise customers are increasingly interested in managed and professional services capabilities, and I believe we are well positioned in these areas.

One last area I would like to discuss is the evolving Wireline business model. Specifically I'm referring to the continuing transformation of our network, products and services, customer interfaces, capital program, workforce and cost structure. I think you are well aware of the strategic divestitures and investments we have made to accelerate growth in the consumer broadband and video market and in the global enterprise market. And you also know that these transformative moves have changed our revenue mix and driven improvement in topline performance. But there is more to do. The investments in broadband, video and global IP will also help us transform the cost structure of our business. For example, the FiOS platform creates an enormous opportunity for consumers to purchase innovative products and services, which will drive revenue growth.

But it also enables us to develop a business model with a different lower cost structure with less reliance on our traditional copper network infrastructure. The changes we recently made in our Wireline organization are to simplify the business and accelerate getting bottom-line performance. We believe this is the right time to do this, and we are in the process of aligning our cost structure to improve productivity.



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From a headcount perspective, as the businesses change, we have been shifting force to the growth areas and steadily reducing our overall workforce. But we need to do more and at an accelerated pace. Our goal in the second half of 2009 is to downsize by more than 8000 in workforce and contractors. We reduced Wireline headcount by 4000 in the third quarter, and we are on track to downsize by at least that amount in the fourth quarter. Total headcount was down 5000 from the end of last quarter.

Along with these force reductions, we are also looking at a comprehensive redesign of our entire call center infrastructure, including reducing the number of call centers and improving our utilization and efficiency metrics. And we have a Wireline network convergence initiative underway that will result in operating efficiency improvements.

Throughout the year we have been very focused on improving our capital efficiency and operating with a great deal of financial discipline. Wireline capital spending is down by \$704 million or 9.6% year-to-date and should continue to run below last year's levels.

I mentioned earlier how tightly we are managing these costs, and we will continue to do so. I am expecting that we will substantially complete our FiOS build program by the end of 2010, which alone should result in about \$2 billion of capital savings each year. Obviously this will significantly reduce our capital requirements beginning in 2011, thus improving free cash flow and investment returns.

I'm confident that the steps we will be taking will simplify our organization, improve our ability to capitalize on new avenues of growth and achieve improved levels of productivity. So to quickly sum up, we turned in another quarter of solid growth in all our strategic areas. Our cash flow growth remains strong, and our balance sheet is healthy and we will continue to improve over the next few years as we reduce Wireless debt. We have industry-leading margins in our Wireless business with tremendous growth opportunities ahead in mobile broadband.

As I just discussed, we will continue transforming the Wireline business. On the strategic front, our Alltel integration continues to go very well, and our access line divestitures are on track.

And with that, I would like to turn it back to Ron.

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**Ron Lataille** - Verizon - SVP, IR

Thank you, John. Brad, Ivan and John are now available to take questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions). John Hodulik, UBS.

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**John Hodulik** - UBS - Analyst

Could you talk a little bit about the Wireless market in terms of the competitive pressure you are seeing? We saw some new pricing out from T-Mobile today, and correspondingly I think both Verizon and AT&T saw sort of lower minutes of usage. So if you could talk a little bit, maybe separate the business or the data side from the voice side and what you see going forward.

And then Ivan, while we have you, could you just update us on where we are in terms of the access line spin? If you are seeing any potential slowdown from a regulatory standpoint in light of what we saw from Fairpoint today. That would be great.





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**John Killian** - Verizon - EVP & CFO

I will start on the wireless side. We were pleased with our quarter. When you look at net adds, 1.2 million in total, 970,000 on the retail side. We thought it was very good performance in the third quarter. We are very excited about the opportunity ahead of us in the fourth quarter. Many of you have seen the advertising that we have had out for the launch of the Droid. We announced really today that the Storm 2 will be available starting Wednesday. I happen to be using the Storm 2, and it is a great enhancement from where we were before. The Droid device, a number of our Wireless team and Shaygan are using it in prelaunch and really think it is going to be groundbreaking and have a lot of opportunity.

We continue to see very good growth on data ARPU. Obviously we are watching all of the pricing changes, the T-Mobile changes, John, just came out overnight. They look to be on the conservative side of what all the rumors were in terms of what was going to happen with that pricing. We really don't see it breaking new ground, don't see in our mind a need to respond to that. I think the other point here I would make is our network, we believe, continues to differentiate ourselves and puts us in a very good position.

**Ivan Seidenberg** - Verizon - Chairman & CEO

And John, on the access line spins, the regulatory proceedings are moving along. There are three or four jurisdictions that are getting closest to decisions. Frontier has done a very good job at differentiating why this transaction is different than any of the previous transactions. So we are still confident that this will get closed on time.

**Operator**

Simon Flannery, Morgan Stanley.

**Simon Flannery** - Morgan Stanley - Analyst

John, you talked in your comments about the LTE rollout. Can you help us think about the capital spending, the potential dilution from there? What are we seeing in terms of your spending the second half of this year and next year? Are you able to pretty much incorporate this into sort of run-rate CapEx and run-rate margins, or is there likely to be some additional pressure from that?

**John Killian** - Verizon - EVP & CFO

Yes, from a CapEx perspective, we put guidance out back in September for the full year of 2009 of a range of \$17.4 billion to \$17.8 billion. I am sure you have already done the math, and in order to hit the low end of that, we would have to spend about \$5 billion of CapEx in the fourth quarter. We have been spending something like \$4.3 billion, around that per quarter in that range.

So at worst case, we're going to be on the very low end of the \$17.4 billion to \$17.8 billion. I actually think we will do better than that and run below that for the full year.

The LTE rollout we are spending some capital on LTE in 2009. As you know, we are in trial mode right now. I do not see that being incremental. I see our ability to absorb that within run-rates of existing capital. We have, as you look ahead to 2010, in '09 we had more spending on Alltel integration, capital. We won't have much of that in 2010. So I don't think you're really going to see any blip whatsoever from the LTE program.



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**Operator**

Michael Rollins, Citigroup Investment Research.

**Michael Rollins - Citigroup Investment Research - Analyst**

Just to follow-up on some of your comments on the enterprise side of the business, both -- actually enterprise and wholesale as well. Enterprise and wholesale showed an uptick sequentially. Should we be surprised by that in the context of the comments you made about the business conditions being on the softer side? And, as you look at the competitive landscape, are you seeing more pricing pressure, or is the pressures on revenue on a year on year basis more a volume issue?

**John Killian - Verizon - EVP & CFO**

Yes, we are very pleased with where our enterprise business is. We have been saying that repeatedly over the last couple of quarters. We have had great success in the marketplace with customer relationships. We have won several new deals. We really have had virtually no defections. So the business is performing extremely well. We were pleased with the sequential growth in revenue, that revenue was up 2.5%. We are showing improvements there. I think a lot of that is driven by the success we have had with various wins in the marketplace. We are seeing CIOs start to be a little bit more willing to spend on new capital, new initiatives. We still see a slight drag from employment that we think once employment really comes back in a bigger way we will do extremely well in the enterprise space and we are very well positioned.

Our sales funnels are very strong. The sales force, I still have personally a lot of discussions with the sales team. Visit customers with them from time to time. I think we have a lot of opportunities globally in front of us, not just domestically in the US. Another point we made was we saw basically no sequential decline in LD minutes going over the network.

So sequentially we saw some stabilization there. Year on year we were down but from that perspective. Pricing is about where it is. We have not seen much of a drop on the pricing side. We have seen more stability. That is what we would expect as we go through and enter 2010.

**Operator**

David Barden, Bank of America/Merrill Lynch.

**David Barden - Bank of America/Merrill Lynch - Analyst**

A couple on Wireless if I could. John, with respect to the Alltel transaction and the synergies we are targeting for run-rate by the end of the year and into next. Could you kind of update us with respect to your thinking on balancing how you are deploying that margin competitively in the market from a handset perspective? Should we be seeing now -- even though it is a seasonally tougher marketing quarter, should we be looking for rising margins again in Wireless as a function of that?

If I could on Wireline go back to comments you made a few weeks ago about Wireline, you were more conservative on Wireline margins coming into the third quarter, looking for growth into fourth quarter in 2010. I'm wondering if based on your plans you can reiterate or clarify those expectations for Wireline margin?





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**John Killian - Verizon - EVP & CFO**

Yes, Dave, a lot there on the questions, so let me see if I can hit the items. So when you take Alltel to begin with, we are very pleased with the Alltel transaction. We are well ahead in terms of integration. We have converted all of the four area billing systems onto Verizon. Our team has done a terrific job with rebranding, capturing the roaming synergies. We have said for the full year we would have \$500 million to \$600 million of expense synergies. We are very confident with that and think we will have a nice contribution in 2010.

From a margin perspective, we have had three quarters in a row of 46%. We have always said we are very focused on balancing both growth and profitability, and we continue to be focused there. The synergies, there is a number of moving parts in the Wireless business beyond just the synergy and equipment subsidies or cost of acquisition. If you actually look at equipment subsidies, they were down on a per unit basis in the third quarter from the second quarter.

Our operating team at times wanted to be a little bit more aggressive in the quarter. We intentionally held them back recognizing that we had more of our product launches coming in the fourth quarter, and we are very excited about the product launches we have coming along.

So we are very confident in the Wireless business, continuing to grow, continuing to deliver the industry-leading profitability that it has been delivering; continuing to grow cash flow because cash flow is extremely strong in that business.

Now on the Wireline side, we are very confident that we have all of the right initiatives in place to improve margin over time. We are focused on the FiOS side. We are pleased with FiOS development. Focused on continuing to drive penetration. We continue to look at all kinds of revenue opportunities in that business. We think FiOS will continue to expand opportunities to enhance revenue.

From a cost standpoint, there is not a line of costs that we are not focused on. As you know, we had said we would reduce the workforce including contractors by at least 8000 in the second half of the year. Total business we reduced 5000 this quarter. The Wireline side we reduced 4000. We are well on track for the cost reduction efforts. We have all other areas of both SG&A, so real estate, procurement, call centers. We have plans in all of those areas to continue to take costs out of the equation.

We are also watching our capital spend in that business. We think we will get some help ultimately as the economy comes back in the enterprise and wholesale space. So we think we have got all of the right initiatives to drive that margin improvement over time.

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**Operator**

Phil Cusick, Macquarie.

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**Phil Cusick - Macquarie - Analyst**

I wonder if we can talk about your device strategy a little bit. Your integrated devices are ramping up really quickly. Where do you expect that to be as a portion of the mix next year? And then how do you plan to focus? Do you want to focus on really the differentiated devices here, but you have got Palm Pre and I do believe Pixi coming fairly soon. Are you just going to have a wide range and then focus on a couple that are very differentiated?

And finally, within that also the Android app store or Palm app store versus your own application suite, how do you think about that these days? Does it even matter anymore?



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**John Killian** - Verizon - EVP & CFO

From a device perspective here, we have always said that we were going to have a wide array of product offerings in our lineup. We have continued to do that. We rolled out in July the BlackBerry tour. That has done extremely well for us. We believe it will continue to do well. Storm 2 being launched this week.

We are, I mentioned on the front end here, working very closely on Android-based devices. And I want to make the distinction that the Droid will have very different capabilities. Yes, it uses the Android open platform, but the design of the set by Motorola, the browsing capability, the speed, we believe, will really set us apart.

We will be introducing the Palm early next year, but our focus right now is maximizing the devices that we are launching in the fourth quarter right now.

From an applications perspective, we will be launching the V CAST Applications store later this year. We are working with over 1000 developers on that right now. We had our Open Development conference. So we see a huge opportunity to generate additional data revenue, additional subscribers from the applications work that we are doing. So we think we are in a very well -- good position. Ivan wants to add a comment.

**Ivan Seidenberg** - Verizon - Chairman & CEO

Just to add sort of a strategic framework for this, the other way that we would ask our investors to think about this is, when you deploy 4G, that really pushes you to think about a broad array of devices as opposed to just the specific smart devices that we see out there now. The ones that are out there now are terrific. They are getting better.

So when you look at 4G and then you look at machine to machine, data revenue opportunity will come in so many different places that we would want to make sure that our strategy has the breadth to capture a lot of things and not focus just on any one or two or three devices. So our view is to lay the groundwork for a very broad array of data growth, which leads obviously to the combination of integrated applications, video and also to sophisticated data applications.

**Operator**

Chris King, Stifel Nicolaus.

**Chris King** - Stifel Nicolaus - Analyst

Two quick questions. First of all, with respect to LTE, just to follow-up on your last comment there, I was wondering if there was any change really -- the LTE handset development timeline that you guys were looking at from your various vendors? In other words, are you guys still planning on essentially doing broadband laptop cards and the like next year over the 100 million pops you plan to have done by year-end?

And then secondly, it may be a little too early for this, but I just wanted to see if you guys had an initial take on pension and OPEB costs going into 2010 and how we should begin to think about that from an earnings standpoint?

**John Killian** - Verizon - EVP & CFO

Okay. Chris, on LTE in terms of devices, really no change from what we were thinking before. The initial rollout will be with laptop air cards, broadband access applications. I think we do believe as LTE begins to get more and more excitement, which we think it is, and you see more and more carriers start talking about it, even on the handset side, people will start looking to move more aggressively. But that is our initial plan there.





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On pension and OPEB, of course, it is too early to give you any kind of indication for 2010. Obviously the factors that will drive this is what is the ROA this year on our assets. We are performing well, as you would expect, through the end of September, and October looks like it's going to be a pretty good month. So we think that will probably be good.

Discount rate will be another factor. We will have to see where that is as we end at year-end. Our employee levels are changing, and that will also be an impact here. But we are not ready to provide any guidance on 2010.

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**Operator**

Tim Horan, Oppenheimer.

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**Tim Horan - Oppenheimer - Analyst**

Ivan, while we have you, maybe a couple of strategic questions. Can you maybe talk about where we think the industry is going with the Wireline/Wireless integration? Is it more important to enterprise versus consumer?

I guess related to the second part of that is, how important is having this capability on a global basis? It seems like you were emphasizing it a little bit more in the press release.

And then a third -- maybe you can't comment on it too much -- but on the iPhone, could you talk about if you guys would like to get the iPhone or not and maybe why Apple would not build a CDMA version of the iPhone for the US?

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**Ivan Seidenberg - Verizon - Chairman & CEO**

I think the way we think about what you call Wireline integration is we have a chance of developing combinations of applications around these services. So rather than just a bundling of the products -- so, as you know, we just introduced a Quad-Play. We have other forms of products that we have in the pipeline where you will be able to use your handsets from Wireless to do different things on your fixed line network.

So our view of this integration is very important, and I think it is important because it adds a marginal expansion of revenue growth in places where that we can develop these kind of cross integration products.

I think globally the reason we emphasize that is that we feel we have a really strong BlackBerry lineup, and we have a lot of new devices coming out. We have lots of great capabilities in our global IP network, and as John said earlier, we feel we are well positioned in our enterprise space.

So I think you will see us from a global standpoint focus mostly our efforts there on the business market. We are doing that.

Now in terms of the iPhone, there is nothing really different about this. I think Lowell would remind us all that this is a decision that is exclusively in Apple's court. We obviously would be interested at any point in the future they thought it would make sense for them to have us as a partner. And so we will leave it with them on that score.

I have no further thoughts about why they may have done whatever they did. What they have done has been successful, so we have to sit back and give them credit for that.

But in the future, what we have done is what John said earlier. We have expanded our BlackBerry base. We have expanded our base of other devices. We now have the Droid coming out. We have an updated Storm coming out. We have application stores coming out.



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So I think our view is to broaden the base of choice for customers, and hopefully along the way, Apple, as well as others, will decide to jump on the bandwagon.

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**Operator**

Jason Armstrong, Goldman Sachs.

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**Jason Armstrong - Goldman Sachs - Analyst**

A couple of questions, maybe first back to just the Wireline margin compression we have seen, just maybe more of a hindsight type of question.

As you think about the different segments -- enterprise, wholesale and consumer -- which segment would you say you are experiencing disproportionately higher margin pressure to this point?

And then just a second question quickly on FiOS metrics, you took up pricing in the quarter. You pulled off some of the promotional activity, which sort of had an expected hit to the net add trajectory to some extent.

Now, as we look forward, is this sort of a new run-rate of net add growth that we should think about as you guys look to balance growth with the return profile?

---

**John Killian - Verizon - EVP & CFO**

If you look at the margin compression, enterprise has held up fairly well. We have had the revenue declines, but on a relative basis, we knew that was coming. We were able to take costs out fairly early in the process. So enterprise has held up relatively well.

Consumer we have had a little bit more pressure. Now that was expected as you are in the middle of the FiOS rollout. You're being aggressive in terms of customer acquisition. You have some of the secular change going on. You experience a little bit more pressure on that side.

From a Wireless run-rate, we indicated that we thought we had the ability to continue to grow at about 1 million postpaid net adds per quarter, 1 million net adds, and we performed well in the third quarter. We are not about to say we are going to limit the possibility of growth. We think we have a great lineup in the fourth quarter, a great lineup as we enter 2010. With LTE coming, we think there are substantial growth opportunities ahead of us.

I mentioned earlier we kind of kept our powder a little bit dry. We actually spent less advertising dollars in the third quarter than we had in the second quarter. Part of that was we knew when the new device lineup was coming in the fourth quarter. So we are still very optimistic and bullish about the ability to grow the Wireless business.

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**Jason Armstrong - Goldman Sachs - Analyst**

Hey, thanks for that, John. The second part of the question was actually more on FiOS metrics on the Wireline side where you took up pricing and then pulled off some of the promotions. I am just wondering if we sort of reset to a new net add profile on that side of the business?





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**Ivan Seidenberg** - Verizon - Chairman & CEO

Yes, I think I would like to answer that from an operating standpoint and then if John wants to clarify it further. I don't think we intend to reset.

What happened is, at the very beginning of the year, we had targeted about 1 million plus, and we had a couple of good quarters in a row. And so we try to see how much we can continue to supercharge that.

As it turns out, we had a couple of promotions that did not work as well. So I don't think it is a question of, are we resetting it. We never changed our view of 1 million. What happened is we had a couple of better quarters. We toyed with how we could sustain that and found it was difficult in light of maintaining a fiscal discipline against it. So the issue is we have never changed off of the 1 million plus.

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**Ron Lataille** - Verizon - SVP, IR

Okay, Jason. Thanks for your question. Brad, that concludes our question session. What I would like to do now is hand it over to Ivan for some concluding remarks.

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**Ivan Seidenberg** - Verizon - Chairman & CEO

Okay. Just a couple of quick points. I think the third quarter for us was a good balancing quarter for us to get line of sight on what we feel we need to do for the rest of this year and as we prepare ourselves for 2010.

What we found is that we focus a great deal on balancing our growth against our margin performance and our net income performance. And, as we go forward, we have better line of sight now in terms of what we feel that we need to do to accelerate data growth in wireless through handset deployment, application deployment and focus on the fundamentals in that business to improve our net add performance as we go into next year.

In the Wireline business, our view is, as John said, we have good line of sight in where we think enterprise is. What we need to do in consumer is maintain the focus on revenue growth as it relates to FiOS and data and to balance the net add costs, but at the same time pick up the pace in our efficiency initiatives, which we have a lot in place. And you are seeing the benefits of some of that begin to take hold in the third and fourth quarter of this year.

So looking out into 2010, I think our Company feels that we have good line of sight in terms of what we need to do to do a better job next year than we have done this year. Okay. Thanks.

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**Ron Lataille** - Verizon - SVP, IR

Thanks, Ivan. That concludes our call today, and I thank everybody for joining us.

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**Operator**

This concludes the call. You can now disconnect. Thank you for participating in today's conference.

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CNET News

# Verizon nears Fios network completion

Verizon Communications is almost finished building its Fios fiber-to-the-home network.

by **Marguerite Reardon** | March 29, 2010 1:54 PM PDT

Verizon Communications is nearly finished building its Fios fiber-to-the-home network. And now it will concentrate on expanding its customer base, say executives.

Verizon, which began building its all-fiber network nearly six years ago, is quickly approaching its goal of passing 18 million homes in about 70 percent of its original customer footprint by the end of this year.

Verizon **took a bold risk when it decided to build the Fios fiber network.**

**[[http://www.cnet.com/Verizons-fiber-race-is-on/2100-1034\\_3-](http://www.cnet.com/Verizons-fiber-race-is-on/2100-1034_3-5275171.html)**

**5275171.html]** Its telecommunications counterpart SBC Communications, which is now AT&T, **decided to invest substantially less capital**

**[[http://www.cnet.com/SBC-to-invest-4-billion-in-fiber-upgrade/2100-](http://www.cnet.com/SBC-to-invest-4-billion-in-fiber-upgrade/2100-1034_3-5449219.html)**

**1034\_3-5449219.html]** to extend fiber to the node or to the neighborhood. AT&T, which uses existing copper lines to deliver service to customers, said it would invest \$4 billion in upgrading its network. Verizon committed to spending \$22.9 billion.



Initially, Wall Street was skeptical about Verizon's bet. It costs Verizon about \$750 per customer to wire an entire neighborhood for the Fios Fiber service. And for every customer who signs up for service, Verizon spends an additional \$600 to bring wire directly to the home.

Six years into the deployment, it looks like Verizon's **investment is paying off.**

**[[http://www.cnet.com/Verizons-fiber-optic-payoff/2100-1034\\_3-](http://www.cnet.com/Verizons-fiber-optic-payoff/2100-1034_3-6192440.html)**

**6192440.html]** The new network has allowed Verizon to add TV services to its lineup as well as blazing fast Internet speeds. Today Verizon **offers 50Mbps download**

**services to its Fios customers. [[http://www.cnet.com/8301-30686\\_3-](http://www.cnet.com/8301-30686_3-10465098-266.html)**

**10465098-266.html]** And it can easily upgrade that service to 100 megabits per second. Meanwhile, AT&T, which announced a less expensive upgrade path, is only able

to **offer a maximum of 24Mbps downloads [[http://www.cnet.com/8301-30686\\_3-20001354-266.html](http://www.cnet.com/8301-30686_3-20001354-266.html)]** to its high-speed Internet customers.

Verizon's service has also been successful in bringing competition to many markets where only cable had been offered TV, voice, and Internet service. At the end of 2009, Verizon's Fios TV service achieved 25 percent market share nationwide, said Bill Kula, a spokesman for Verizon. Its Internet service has reached 28 percent penetration nationwide. In the next couple of years, Verizon hopes to bump that penetration up to between 35 percent and 40 percent for both services, Kula added.



Verizon Communications kicks off Fios in New York City in 2008 with a special event to recruit new subscribers.

(Credit: Marguerite Reardon/CNET )

And in markets where Verizon's Fios service has been around the longest, insiders report penetration rates have exceeded 50 percent for Fios high-speed Internet and are approaching 50 percent for Fios TV.

But as Verizon nears the completion of its initial goal, the company is taking a breather from construction. Executives have explained that the building phase of the network is essentially winding down. It is focusing now on finishing up TV franchises in markets where it has been working out agreements, and it's continuing to build out networks in markets it has already announced. For example, Verizon is continuing to lay fiber in parts of Washington, D.C, New York City, and Philadelphia. But it has no plans to start new deployments in cities, such as Baltimore or downtown Boston, Kula said.

"As we get closer to the end of the year, you'll see a greater focus on sales and marketing for Fios and less on engineering and construction," Kula said. "This is the reverse of what it was in the beginning, when we were focused on building the network. Back then we weren't doing as much marketing because we were just trying to build out the service."

Kula said that in areas where Fios already exists, the company will continue to compete aggressively on bundled pricing. It will also offer cash back incentives from \$75 to \$200



as well as offers of new Netbooks for customers who sign up for the service for the first time.

Previously, Verizon had offered new Fios TV customers a free 19-inch high-definition TV.

There are indications that new customer wins are slowing. Verizon **added only 153,000 new Fios TV subscribers in the fourth quarter of 2009.** [[http://www.cnet.com/8301-30686\\_3-10441167-266.html](http://www.cnet.com/8301-30686_3-10441167-266.html)] This was about half of what the company had added during the same quarter a year earlier. At the end of 2008, Verizon had added 303,000 new Fios TV subscribers.

In total, Verizon ended 2009 with 2.86 million Fios TV subscribers and 3.43 million Fios Internet subscribers. Most customers take both services, but some Internet subscribers don't yet have access to TV services.

The Federal Communications Commission has applauded Verizon for its investment in fiber. The FCC has put together a 10-year **National Broadband Plan** [[http://www.cnet.com/8301-30686\\_3-20000453-266.html](http://www.cnet.com/8301-30686_3-20000453-266.html)] to encourage affordable broadband service for every American. And there is no question that the FCC would like to see companies, like Verizon, investing even more in building new infrastructure.

Verizon hasn't ruled out deploying more fiber in the future. The initial plan for Fios covers about 70 percent of Verizon's traditional telephone customers. This means that 30 percent of Verizon's customers won't get Fios. Kula said these customers can expect continued investment in DSL broadband service as well as wireless broadband investment. Verizon is currently building a 4G wireless network using a technology called LTE, or Long Term Evolution.

But there is no guarantee that Verizon will target areas of the country where it doesn't offer Fios with its LTE services. Verizon Wireless, which is owned by Vodafone and Verizon Communications, has said it will **launch the 4G service in 25 to 30 markets by the end of the year.** [[http://reviews.cnet.com/8301-13970\\_7-10453550-78.html](http://reviews.cnet.com/8301-13970_7-10453550-78.html)] Executives at Verizon Wireless have indicated that the rollout will look similar to the deployment of services for 3G wireless. If this is the case, it's likely that 4G wireless broadband will initially be deployed in dense urban areas, many of which also have Fios service.

Verizon has also been selling off its wireline assets in rural areas. Almost a year ago, Verizon **announced plans to sell local phone lines in 14 states to Frontier Communications** [[http://www.cnet.com/8301-1035\\_3-10239539-94.html](http://www.cnet.com/8301-1035_3-10239539-94.html)] in a deal valued at \$8.6 billion.

As part of this deal with Frontier, Verizon is selling some of its existing Fios deployments. Initially, Verizon deployed Fios in 16 states. Now, Fios service in four of those states--Washington, Oregon, Indiana, and South Carolina--will go to Frontier. In

total, Verizon will lose about 750,000 potential subscribers through this transaction. Kula said that Frontier has agreed to continue servicing existing Fios subscribers.

Verizon has reiterated that it never planned to deliver fiber service to 100 percent of its wireline territory, which covers 32 million potential customers today. (After the divestiture of assets to Frontier that number will be 27 million.) But the popularity of the Fios service, and the strong competition that comes with it, will certainly leave many customers in areas where Fios has not been built disappointed.

**<http://www.cnet.com/profile/MaggieReardon/>**

**Marguerite Reardon** **<http://www.cnet.com/profile/MaggieReardon/>**

Marguerite Reardon has been a CNET News reporter since 2004, covering cell phone services, broadband, citywide Wi-Fi, the Net neutrality debate, as well as the ongoing consolidation of the phone companies.



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# Verizon winds down expensive FiOS expansion

Updated 3/26/2010 5:02 PM

By Peter Svensson, Associated Press



By Dan MacMedan, USA TODAY

Verizon employee Larry Hames, with his partner David Fell behind him, splices the new fiber optic lines together in a Long Beach, CA neighborhood.

**NEW YORK** — If Verizon Communications hasn't already started wiring your city or town with its FiOS fiber-optic TV and broadband service, chances are you won't get it.

Where it's available, FiOS usually provides the only competition for cable TV apart from satellite service. Studies have shown that its entry into an area leads to lower cable prices, though FiOS itself has not

been undercutting cable TV prices substantially.

But Verizon is nearing the end of its program to replace copper phone lines with optical fibers that provide much higher Internet speeds and TV service. Its focus is now on completing the network in the communities where it's already secured "franchises," the rights to sell TV service that rivals cable, said spokeswoman Heather Wilner.

That means Verizon will continue to pull fiber to homes in Washington, D.C., New York City and Philadelphia— projects that will take years to complete — but leaves such major cities as Baltimore and downtown Boston without FiOS.

Verizon is still negotiating for franchises in some smaller communities, mainly in New York, Massachusetts and Pennsylvania, but it is not working on securing franchises for any major urban areas, Wilner said. For instance, it's halted negotiations for the Washington suburb of Alexandria, Va.

Verizon never committed to bringing FiOS to its entire local-phone service area. It has introduced FiOS in 16 states, but the deployment is concentrated on the East Coast, and Verizon is selling off most of its service areas in the Midwest and on the West Coast. Its stated goal was to make FiOS available to 18 million households by the end of 2010, and it's on track to reach or exceed that.

That will still leave a third of its service area (excluding the territories it is selling) without fiber. And as Verizon has signaled this month that it's focusing on communities where it already has

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franchises, it's now becoming clear which ones are in and which are out.

The New York-based company hinted in 2008 that it might continue expansion of FiOS beyond this year, but the recession seems to have crimped that possibility. The company has pulled back on promotions for new subscribers, like the 19-inch TVs it gave away under one campaign. That in turn has led to lower recruitment figures.

CEO Ivan Seidenberg told investors in January that FiOS itself has been doing well, but Verizon's sales of services to large businesses have suffered in the downturn, and it needed to offset that by not being too "aggressive" in marketing FiOS.

Verizon doesn't appear to have ruled out further FiOS expansion, but doesn't have any plans, either. The economics apparently are not attractive enough: TV service carries fairly low margins compared to Verizon's phone business, according to analyst Craig Moffett at Sanford Bernstein.

Moffett believes the end of FiOS expansion means that cable companies will lose fewer subscribers, starting next year.

The recruitment of new FiOS TV subscribers slowed last year. In the fourth quarter, it added 153,000 subscribers, little more than half of the number it added in the same period the year before.

At the end of last year, Verizon had 2.86 million FiOS TV subscribers and 3.43 million FiOS Internet subscribers (most households take both).

Verizon has faced skepticism from investors over the project because of the high costs. Wiring a neighborhood for FiOS costs Verizon about \$750 per home. Actually connecting a home to the network costs another \$600. The total cost from 2004 to 2010 was budgeted at \$23 billion. But it's allowed Verizon to mount an effective resistance to cable companies, which are siphoning off landline phone customers and can offer higher broadband speeds than phone companies without fiber straight to homes can.

Verizon is the only major U.S. phone company to draw fiber all the way to homes and the only one to offer broadband speeds approaching those available in Japan and South Korea. The halt to further expansion comes as the Federal Communications Commission has sent Congress the country's first "national broadband plan," aimed at

making Internet access faster, more affordable and more widely available.

AT&T and Qwest Communications International are laying fiber into neighborhoods, but still use copper phone lines to take the signal the last stretch of the way, into homes. That's a less costly strategy that has drawn less scrutiny from Wall Street, but it also limits top broadband speeds. Meanwhile, cable companies are upgrading modems this year to offer higher speeds, a relatively inexpensive move.

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## Cox Communications to Discontinue Cox Wireless Service, Effective March 30, 2012

### Cox Easing Customers' Transition to Alternate Wireless Service Providers

**ATLANTA – November 15, 2011** – Cox Communications announced that it will discontinue selling Cox Wireless, its wireless phone service, effective November 16, 2011. Cox will continue providing service for its wireless customers through March 30, 2012, and special offers will be available to Cox Wireless customers to ease their transition to another wireless provider.

"Cox is working to make this transition as seamless and easy as possible for our customers," said Len Barlik, executive vice president of product development and management. "We are proud of our employees' dedication to delivering the excellent customer service that Cox is known for, and we will continue to keep our wireless customers' satisfaction a top priority during this transition period."

All Cox Wireless customers have multiple Cox services, and will receive a \$150 credit on their bill for every line of wireless phone service disconnected. Customers can keep their wireless devices and all early termination fees will be waived. Also, wireless customers will continue to receive their Bundle Benefit™ for two years.

"We understand the importance of wireless to the customer experience," said Barlik. "Cox is looking at several options to continuously increase the value of our bundle of services."

Cox's decision to no longer sell its 3G wireless service was based on the lack of wireless scale necessary to compete in the marketplace, the acceleration of competitive 4G networks as well as the inability to access iconic wireless devices. Cox had launched wireless service in less than 50 percent of its footprint, including: Hampton Roads, Roanoke and Northern Virginia; Orange County, San Diego and Santa Barbara, Calif.; Omaha, Nebraska; Oklahoma City and Tulsa, Okla.; and Rhode Island and Cox communities we serve in Connecticut and Cleveland, Ohio.

Cox's television, high speed Internet, residential phone and commercial services will be unaffected by the change.

#### About Cox Communications:

Cox Communications is a broadband communications and entertainment company, providing advanced digital video, Internet, and telephone services over its own nationwide IP network. The third-largest U.S. cable TV company, Cox serves more than 6 million residences and businesses. Cox Business is a facilities-based provider of voice, video and data solutions for commercial customers, and Cox Media is a full-service provider of national and local cable spot and new media advertising. Cox is known for its pioneering efforts in cable telephone and commercial services, industry-leading customer care and its outstanding workplaces. For seven years, Cox has been recognized as the top operator for women by Women in Cable Telecommunications; for six years, Cox has ranked among DiversityInc's Top 50 Companies for Diversity, and the company holds a perfect score in the Human Rights Campaign's Corporate Equality Index. More information about Cox Communications, a wholly owned subsidiary of Cox Enterprises, is available at [www.cox.com](http://www.cox.com) and [www.coxmedia.com](http://www.coxmedia.com).

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## **Federal Trade Commission Protecting America's Consumers**

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### **13TH ANNUAL ADVANCED ALI-ABA COURSE OF STUDY VERTICAL ISSUES IN FEDERAL ANTITRUST LAW**

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**Remarks of Commissioner Sheila F. Anthony**

**March 19, 1998**

#### **INTRODUCTION**

It is a pleasure to be here in San Francisco, even with El Nino, to participate with such a distinguished panel in this ALI-ABA program on "Product Distribution and Marketing." This afternoon I will address vertical issues in federal antitrust law. Vertical antitrust issues arise in the context of relationships -- contractual or through merger -- between businesses at different levels in the chain of distribution; for example, between the maker of military aircraft and the maker of stealth radar technology. During my relatively brief tenure at the Federal Trade Commission -- barely six months -- I have dealt with several cases involving vertical antitrust issues and I have a new appreciation for the difficulty of this area of law.

Antitrust treatment of vertical restraints and mergers has vacillated over the years, in large part because vertical issues raise complicated analytic problems of how to resolve the conflict between generally acknowledged efficiencies stemming from vertical relationships and the potential for anticompetitive harm.<sup>(1)</sup> Both the courts and the antitrust agencies have struggled with two key issues related to vertical alliances:

- First, how do they cause anticompetitive harm?
- Second, how should the analysis treat the substantial efficiencies that they generate?

The answers to these questions are fact and case specific. Despite being somewhat of a newcomer to these issues, I will attempt to share some of what I have learned over the last six months and to discuss several recent Federal Trade Commission cases involving vertical antitrust issues. But first, I must make the standard disclaimer that the views expressed are my own and do not necessarily represent the views of the Commission or any other Commissioner.

#### **AGREEMENT AS A THRESHOLD ISSUE**

When analyzing any vertical relationship, a threshold issue is whether there is an agreement. An agreement for Sherman and FTC Act purposes is defined as "a conscious commitment to a common scheme designed to achieve an unlawful objective."<sup>(2)</sup> The evidence must show that the manufacturer and distributor did not act independently.<sup>(3)</sup> Determining whether an agreement existed, however, is not an easy task -- antitrust conspirators rarely sign a contract clearly spelling out the parameters of their anticompetitive agreement. Thus, antitrust enforcers must examine the totality of the circumstances.

#### **RULE OF REASON ANALYSIS**

The finding of an agreement is just the start of the inquiry. Most vertical alliances must be analyzed under a complicated "rule of reason," except in the area of minimum resale price maintenance, which is per se illegal. The rule of reason analysis takes account of many factors, including geographic and product market definition, market power, effects on intrabrand competition (such as competition among Ford dealerships), effects on interbrand competition (such as competition between Ford and GM dealerships), and any business justifications or offsetting efficiencies.

#### **MINIMUM RESALE PRICE AGREEMENTS**

An agreement between manufacturer and dealer or retailer on minimum resale price levels is per se illegal.<sup>(4)</sup> However, under the Colgate Doctrine,<sup>(5)</sup> established by the Supreme Court in 1919, a manufacturer may lawfully suggest prices and stop dealing with those who discount those prices, as long as it does so unilaterally. For example, manufacturers may suggest minimum prices (unilaterally) using a number of techniques, including:

- Providing lists of suggested retail prices;(6)
- Pre-ticketing prices on the product;(7) or
- Advertising suggested prices directly to consumers.(8)

A manufacturer may cut off a discounter in response to complaints from other retailers, as long as it makes this decision unilaterally.(9) Generally, the FTC does not challenge cooperative advertising programs in which dealers must use manufacturer-supplied information, including resale prices, in the advertisements. However, when dealers pay for their own advertisements, they must be free to price the product at whatever level they choose.(10)

Manufacturer actions that attempt to secure compliance with announced minimum prices may result in an improper agreement with the retailer. Such actions may include:

- Threatening to penalize dealers by mixing up orders;(11)
- Requiring manufacturer approval of deviations from suggested prices;(12) or
- Removing all of the financial incentive for a retailer to set a price below the suggested minimums.(13)

### **American Cyanamid -- FTC Consent Alleging Minimum Resale Price Agreement**

Last year the FTC issued a complaint and consent alleging that American Cyanamid fixed the minimum resale prices of its agricultural chemical products. Although the FTC's challenge of a minimum resale price maintenance agreement is not surprising, this case is particularly interesting because of the way in which American Cyanamid structured its dealer agreements. American Cyanamid operated two cash rebate programs for its retail dealers over a five year period. Under these programs, the dealers could receive substantial rebates on each sale of crop protection chemicals, but only if made at or above American Cyanamid's specified minimum resale price. The dealers overwhelmingly accepted the rebate offer by selling at or above the specified prices.

The FTC alleged a per se violation by American Cyanamid because a dealer could not receive a rebate on sales below the specified prices, and therefore would lose money on such sales. American Cyanamid also included performance criteria in its dealer rebate programs that could increase the amount of the rebate. However, if a dealer met all of the performance criteria, but sold the product for less than the specified minimum resale price, that dealer received no rebate on the sale. On the other hand, if the dealer met none of the performance criteria, but sold the product at or above American Cyanamid's specified minimum resale price, the dealer nonetheless received a rebate on that sale.

The FTC alleged that American Cyanamid's conditioning of financial payments on dealers' charging a specified minimum price amounted to the quid pro quo of an agreement. In other cases where this issue has arisen, courts also have treated such agreements as per se illegal.(14)

Another type of potentially problematic conduct is "structured terminations." These are unilateral, manufacturer-announced policies under which a discounter incurs increasing penalties for first, second, and third infractions for failure to sell at the minimum resale price. The FTC has banned such terminations as a part of "fencing-in" relief in a consent order, but has not ruled on their permissibility standing alone.(15)

### **Remedies in Resale Price Maintenance Cases**

The FTC's selection of remedies in minimum resale price maintenance cases will be influenced by the willfulness of the conduct, whether the conduct led to the unlawful agreement, and the seriousness of its probable effects, measured in part by the market power of the manufacturer. For example, the FTC prevented Nintendo(16) from exercising its Colgate rights(17) to terminate or suspend retailers that did not comply with its announced pricing policy. This severe remedy was necessary because Nintendo commanded 80% of the market and, by virtue of this power, could have maintained its policy without an agreement because retailers could feel intimidated.

### **MAXIMUM RESALE PRICE MAINTENANCE**

As you heard this morning, after almost thirty years of per se unlawful treatment, in 1997 the United States Supreme Court reversed itself in *State Oil Co. v. Khan*,(18) and held that *maximum* resale price maintenance is not per se illegal. The Court explained that maximum prices could promote consumer welfare, under certain circumstances, by limiting the ability of a retailer to exercise local monopoly power.(19)

The Department of Justice and the FTC jointly filed an amicus brief in *State Oil Co. v. Khan* that stated, in pertinent part:



"We do not discount the possibility that there are cases in which vertical maximum price fixing may be, on balance, anti-competitive and therefore violate the Sherman Act. . . . Certainly, we do not advocate any rule declaring that vertical maximum pricing arrangements are per se legal. There is no reason to believe, however, that such anti-competitive situations will be frequent, or that those that may arise may not be adequately policed under the rule of reason. We are therefore confident that the loss of [the] per se rule will not materially hamper the federal government's ability to enforce the antitrust laws vigorously in any appropriate case."

It is important to remember that *State Oil Co. v. Khan* does not immunize maximum resale price maintenance; rather, it requires the courts and agencies to examine such arrangements using the rule of reason.

### **NON-PRICE VERTICAL RESTRAINTS -- Exclusive Dealing and Exclusive Distributors**

Non-price vertical restraints include exclusive dealing and exclusive distribution agreements, and both are assessed under the rule of reason.<sup>(20)</sup>

In exclusive *dealing* cases, a manufacturer arranges for a retailer (or customer at some other level) to carry only the manufacturer's line of products, and not the products of a competitor. In exclusive *distribution* cases, instead of retailers committing themselves to a single manufacturer, the manufacturer commits itself to a single retailer to be its sole (or primary) outlet in a particular geographic area. The FTC assesses both exclusive dealing and distribution arrangements using the rule of reason.<sup>(21)</sup> The ultimate question is whether competition has been harmed by the exclusive dealing or distribution arrangements -- that is, has the firm imposing the exclusivity gained power over price?

Thus, exclusive dealing may be procompetitive when it encourages retailers to invest in promoting the manufacturer's line, thereby enhancing interbrand competition at the retail level.<sup>(22)</sup> For example, when Ford Motor Company requires its dealers to sell only Ford cars and trucks, generally this would be procompetitive because General Motors has a similar arrangement with its dealers; thus, there is more aggressive competition between the Ford and GM retailers. Similarly, exclusive distributorships can be procompetitive and normally are permissible, particularly when competing manufacturers, selling through other retailers, also are present in the market.<sup>(23)</sup>

Exclusive dealing and exclusive distribution arrangements may be anticompetitive, however, if they are used to raise rivals' costs, exclude (or foreclose) competition, or facilitate tacit collusion. Exclusive dealing contracts may raise rivals' costs when the contracts are made with so many retailers, and lock up so much capacity at the retail level, that competing manufacturers are unable to attain minimum efficient scale in either the production or the distribution functions.<sup>(24)</sup>

In the recent cases against Waterous Co. and Hale Products, the FTC alleged that the two dominant manufacturers of fire-engine pumps each entered into exclusive dealing agreements with certain manufacturers of fire engines. The FTC was concerned that these exclusive deals facilitated tacit collusion and functioned as a means of allocating customers.

In exclusive distribution cases, a retailer may effectively raise a rival's costs by securing commitments from a sufficient number of manufacturers to prevent a rival from: (1) attaining economies of scale or scope; (2) obtaining low-cost supplies; or (3) obtaining products necessary to satisfy consumer demand. For example, if Sears obtained the exclusive rights to be the sole distributor of appliances made by Maytag, General Electric, and other large appliance manufacturers, such exclusivity could have an anticompetitive effect on other retailers, such as Montgomery Ward and Penney's.

### **VERTICAL MERGERS**

Vertical mergers occur between firms that operate at different but complementary levels in the chain of production or distribution. Common examples include a merger between a manufacturer and a distributor (for example, between a drug manufacturer and a pharmacy benefits manager) or a merger between two manufacturers, one of which produces an end product and the other a component used to make that end product. As with non-price vertical restraints, vertical mergers often can be efficiency-enhancing.

However, vertical mergers also can have anticompetitive effects. Vertical mergers can allow competitors to raise rivals' costs.<sup>(25)</sup> For example, Eli Lilly, a drug manufacturer, could make it more difficult or expensive for competing drug manufacturers to distribute their drug products through Lilly's wholly-owned pharmacy benefits manager, PCS. Vertical mergers also can facilitate coordinated interaction; for example, when the downstream level of the integrated firm receives competitively sensitive information from the competitors of the upstream level of the integrated firm such information could be used to coordinate marketplace behavior.<sup>(26)</sup> In connection with the Lilly/PCS merger, the FTC was concerned that Lilly would be in a position post-merger to obtain from PCS sensitive pricing and bidding information submitted by other drug manufacturers. Such information could allow Lilly to underbid its competitors in an anticompetitive manner.

Some common remedies used in connection with vertical mergers include: